



August 15, 2007

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
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Re: Docket No. OP-1288

Dear Governors:

The American Financial Services Association (“AFSA”) hereby submits this comment letter in connection with the Board of Governors of the Federal Reserve System’s (“Board”) June 14 hearing on the Home Equity and Ownership Protection Act (“HOEPA”) and on the adequacy of existing regulatory and legislative provisions in protecting the interests of consumers. AFSA’s comments regarding HOEPA reflect that the Board along with other federal financial regulatory agencies issued their final interagency Statement on Subprime Mortgage Lending (“Statement”) on June 29, 2007, initially proposed on March 8, 2007 addressing many of the same concerns discussed at the June 14 hearing.

AFSA, founded in 1916, is the trade association for a wide variety of consumer finance companies. AFSA's mission is to protect and improve the consumer credit business, maintain a positive public image, and create a legislative climate in which reasonable credit regulation can and will be enacted. AFSA operates in the public interest, encourages and maintains ethical business practices, and supports financial education for consumers of all ages.

AFSA commends the Board for a robust consideration of how it might use its authority under HOEPA to address concerns about potentially abusive mortgage lending practices. We share and promote the Board’s goal of “encouraging responsible mortgage lending for the benefit of individual consumers” expressed by Gov. Kroszner at the hearing. At the same time, AFSA appreciates that the Board’s desire is to “seriously consider how we might use our rulemaking authority to address abusive practices without restricting consumers’ access to beneficial financing options and responsible subprime credit.”

Toward that end, AFSA encourages the Board to be cautious in exercising its rulemaking authority under Section 129(l) of HOEPA to limit unfair and deceptive practices in mortgage lending. AFSA recommends that the Board consider using its broad authority under Section 105(a) of the Truth in Lending Act (“TILA”) to strengthen and simplify disclosures to address the four specific topics addressed in the hearing.

Whereas Section 129(l) does not authorize new disclosure requirements, Section 105(a) provides broad authority to create such requirements. Any action taken by the Board regarding subprime credit must be based on a clear picture of the subprime credit market.

Subprime Mortgages Benefit the Consumer

In its announcement of the 2007 HOEPA hearing, the Board acknowledges that the availability of subprime credit confers substantial benefits on consumers. The subprime mortgage market has both increased the number of homeowners—particularly among minority groups—and allowed many consumers to repair their credit and qualify for prime loans.

As recently as twenty years ago, the vast majority of lenders would make only prime loans. The availability of a wide array of mortgage products was limited. Consumers with pristine credit histories met strict conventional lending standards and received a prime loan. The only alternative for consumers who could not meet the conventional lending standards were mortgage loans with very high rates. Loan to value ratios on these products were rather low, leaving the consumer with the ability to borrower often less than \$50,000.

With the introduction of risk based pricing models, lenders began to assess the risk of lending money to different borrowers. As a result, the market developed a wider range of products that were better tailored to borrowers' varying circumstances, and tailored to the risk level of the individual borrower. Thus borrowers with higher levels of risk began to benefit not only from having greater access to mortgage credit than ever before, but also in having access to credit products that were more affordable than ever before. Any actions that limit the products available to subprime borrowers or otherwise decrease the availability of mortgage credit to subprime borrowers will deprive many of these consumers from owning or maintaining a home.

In addition to providing many Americans a door to home ownership, the subprime mortgage market provides substantial benefit to consumers facing temporary financial setbacks and return to the "prime" borrowing market. The principal causes of consumer financial difficulties are the same as they were before the availability of subprime credit: job loss, divorce, and major health care expenses.¹ These life events often make it difficult, if not impossible, for consumers to continue making timely payments on all of their existing obligations. As a financial setback causes the consumer's credit score to decrease, a consumer may find it very difficult to repair that credit score without access to new credit. Subprime mortgage products often help consumers withstand financial difficulties and repair previously damaged credit. One national lender recently testified to

¹ Freddie Mac recently reported that over 70% of delinquencies in its portfolio in 2006 were due to such life events, with an additional 13.3% ascribed to unspecified "other" reasons. *See* http://www.freddiemac.com/news/archives/servicing/2007/20070425_singlefamily.html (Apr. 25, 2007).

Congress that 80% of its borrowers who obtained a hybrid ARM between 2000 and 2006 refinanced within 36 months of origination. Of those borrowers who refinanced with that lender, 50% refinanced into a prime loan and 25% refinanced into a subprime fixed-rate loan. The borrowers who refinanced into a prime loan had improved their FICO scores by an average of almost 50 points and benefited from lower interest rates on their new loans.² Thus, subprime loans—including hybrid ARMs—frequently allow consumers to reestablish their credit as well as meet their immediate financial needs. The Board should take into account the important benefits these loans offer to this segment of consumers before imposing limitations on the availability of subprime credit.

Market Responding to the Rise in Delinquencies and Foreclosures

As the Board contemplates utilizing its rulemaking authority, AFSA encourages the Board to recognize the response of the market to the recent rise in delinquencies and foreclosures. With a significant increase in delinquency and foreclosure rates in recent months, investors in the secondary mortgage market responded quickly by tightening their investment guidelines. This led lenders to tighten their credit and underwriting requirements. Many lesser capitalized lenders whose focus was exclusively in the subprime or “Alt-A” market were even forced to shut their doors. At the same time, many lenders maintained prudent, conservative underwriting standards, and have seen much smaller increases in poorly performing loans. Consequently, AFSA asks the Board to recognize that the market has already addressed such standards, and will continue to adjust to respond to economic changes.

While the recent loan performance problem has resulted in a great deal of media attention, recent evidence indicates that the market is correcting. This spring, the House Financial Services Committee heard testimony from numerous witnesses that lenders were working with borrowers and investors to provide loan modifications to many borrowers facing interest rate resets on their ARM products. AFSA has attached a survey of our members’ voluntary foreclosure mitigation efforts as further evidence. Furthermore, the majority of mortgage lenders are already following the Nontraditional Mortgage Guidance that was issued on September 29, 2006, whether or not they are federally regulated or not. The majority of lenders, whether they are federally regulated or not, will follow the recent Subprime Lending Statement.

In addition, AFSA notes that the vast majority of delinquencies and foreclosures are not related to particular loan terms or products, but are due largely to the same factors that have led to delinquencies and foreclosures historically: job losses, divorce, and medical problems. Moreover, the Senate Joint Economic Committee acknowledged in a recent report that “[l]ocal economies, housing market conditions, and regulatory

² Testimony of Sandor Samuels, Executive Managing Director, Countrywide Financial Corporation, before the Senate Committee on Banking, Housing and Urban Affairs, Mar. 22, 2007.

environments can help explain why particular regions are getting hit the hardest by subprime troubles.”³ The General Accountability Office has been asked by Chairman Barney Frank and Representative Spencer Bachus to report on the causes and AFSA hopes that the Board will consider their findings as it contemplates action.

DISCUSSION

As noted above, AFSA encourages the Board to be cautious in exercising its rulemaking authority under Section 129(l) of HOEPA to limit unfair and deceptive practices in mortgage lending. AFSA recommends that the Board consider using its broad authority under Section 105(a) of the Truth in Lending Act (“TILA”) to strengthen and simplify disclosures to address the four specific topics addressed in the hearing.

TILA, as amended by HOEPA, contains two different provisions that authorize the Board to take action against abusive lending practices. These two sections—Section 129(l) and Section 105(a)—are discussed below.

The Board’s Authority Under Section 129(l)

The Board has authority under HOEPA to establish substantive requirements with respect to abusive mortgage lending—and that those requirements would apply to all lenders, not just those subject to the authority of the Board or of another federal banking agency. HOEPA provides:

The Board, by regulation or order, shall prohibit acts or practices in connection with –

(A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section; and

(B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.⁴

Thus, the statute limits the Board’s authority to address either (1) loans that are “unfair,” “deceptive,” or intended to evade HOEPA’s requirements; or (2) refinancing

³ U.S. Senate Joint Economic Committee, *Sheltering Neighborhoods from the Subprime Foreclosure Storm*, at 4 (Apr. 11, 2007), available at <http://jec.senate.gov/Documents/Reports/subprime11apr2007revised.pdf>.

⁴ TILA § 129(l)(2), *codified at* 15 U.S.C. § 1639(l)(2).

that are abusive or not in the best interests of the borrower. Unless a lending practice falls within one of these categories, the Board lacks authority to address it.

Congress was concerned with abusive lending practices in enacting HOEPA. However, Congress also recognized that the imposition of numerous specific prohibitions in an area as complex as residential mortgage lending could prohibit transactions that benefit consumers. Section 129(l) was included “to make sure this legislation [HOEPA] does not have the unintended consequence of making less fair credit available.”⁵ Thus, any Board actions that decrease the availability of fair credit are inconsistent with the congressional intent of Section 129(l).

The Board’s UDAP Guidance

AFSA urges the Board to follow its previous UDAP guidance. The Board has recognized that the determination of whether an act or practice is unfair or deceptive frequently depends on the specific facts or circumstances involved: “Whether an act or practice is unfair or deceptive will in each instance depend upon a careful analysis of the facts and circumstances.”⁶ AFSA encourages the Board to continue to exercise its authority on a case by case basis.

In determining whether a specific act or practice is unfair, the Board has explained that it employs a three-part test:

An act or practice is unfair where it (1) causes or is likely to cause substantial injury to consumers, (2) cannot be reasonably avoided by consumers, and (3) is not outweighed by countervailing benefits to consumers or to competition. Public policy may also be considered in the analysis of whether a particular act or practice is unfair.⁷

The Board has indicated that an act or practice is deemed unfair only if it satisfies all three of these criteria.

Additionally the Board has clarified that it “*will not second-guess the wisdom of particular consumer decisions.*”⁸ Instead, the Board will consider whether a particular act or practice “unreasonably creates or takes advantage of an obstacle to the free

⁵ 140 Con. Rec. S3175 (Mar. 17, 1994).

⁶ Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation *Unfair or Deceptive Acts or Practices by State Chartered Banks* (Mar. 11, 2004).

⁷ *Id.* (emphasis in original).

⁸ *Id.* (emphasis added).

exercise of consumer decision-making.”⁹ Thus, the touchstone is whether the consumer is free to make his or her own decisions. If the act or practice does not impede a consumer’s ability to make decisions, the act or practice is not “unfair” for purposes of a UDAP analysis irrespective of whether the Board agrees with the consumer’s decision.

The Board also follows a three-part test in determining whether a representation, act or omission is deceptive:

First, the representation, omission, or practice must mislead or be likely to mislead the consumer. Second, the consumer’s interpretation of the representation, omission, or practice must be reasonable under the circumstances. Lastly, the misleading representation, omission, or practice must be material.¹⁰

In determining whether a representation, omission or practice is deceptive, the Board has explained it will evaluate it in context.¹¹

Market Reaction to HOEPA Exposure

Violations of the requirements of Section 129 subject lenders to far greater damages than violations of other requirements of TILA. A violation of a requirement of Section 129 results in substantial amounts of litigation. Actions that would result in “endless litigation” are inconsistent with the congressional intent of Section 129(l). Moreover, any failure to comply with a requirement adopted under Section 129(l) arguably could be viewed as an unfair or deceptive practice under state UDAP laws and subject a lender to the substantial damages provided by state UDAP laws.

Nevertheless, these draconian punishments are available only when a failure to comply is “material.” Under Section 130(a)(4) of TILA, a creditor is liable for enhanced damages unless “the creditor demonstrates that the failure to comply is not material.” A failure to provide “material” disclosures under Sections 103(u) or 129(j) also could be considered to extend the right of rescission.

The significant potential exposure lenders face under Section 129(1) of HOEPA has had a substantial impact on the availability of credit to many borrowers. The September, 2005 Fed bulletin article on HMDA notes that following the enactment of HOEPA, the number of HOEPA loans had dwindled to 25,000 nationwide. The Board

⁹ *Id.*

¹⁰ *Id.* at 4.

¹¹ *Id.*

can expect a similar reduction in the availability of credit if more loan products are subject to Section 129(l).

The Board's Authority Under TILA Section 105(a)

In addition to Section 129(l), the Board has broad authority to require disclosures under Section 105(a) of TILA. Section 105(a), codified at 15 U.S.C. § 1604(a), gives the Board broad authority to require disclosures to “effectuate the purposes” of TILA.

Additionally, any new disclosure requirements that the Board may wish to implement are more appropriately promulgated under Section 105(a) than under 129(l). Indeed, Section 129(l) only authorizes the Board to prohibit unfair or deceptive “acts or practices,” not to require new or additional disclosures. Only Section 105(a) expressly authorizes the Board to require new or different disclosures.

While any new or modified disclosure requirement should be promulgated under Section 105(a), there is some risk that if the Board does not clarify that new disclosure requirements are promulgated under Section 105(a), some could mistakenly conclude that they are promulgated under Section 129(l) which could lead to increased litigation for years to come. Given the potential for substantially greater liability under Section 129(l) as discussed above, AFSA urges the Board to clarify that any new disclosure requirement is promulgated pursuant to the Board's authority under Section 105(a).

Answers to Specific Questions

AFSA notes the Board's interest in opinion relating to the effectiveness of state legislation. AFSA members believe that state regulation of mortgage lending has been historically effective. In recent years, however, well-intentioned, experimental laws have often overreached in their efforts to protect consumers, causing significant unintended consequences. The Georgia Fair Lending Act is a compelling example of such a law, requiring repeal within six months of its effective date due to the effect it had on availability of credit. Viewed against laws like this, uniform standards which negate the need for creative state lawmaking have merit.

As noted above, AFSA submits its comments in light of the recent publication of the Statement. The Statement addresses each of the particular issues that were discussed at the June 14 hearing. AFSA believes that lenders, whether they fall directly under the jurisdiction of federal financial regulators or not, will abide the principles outlined therein. However, AFSA members need the flexibility that guidance offers to be able to offer products to consumers who may otherwise be shut out of the market. In addition, some of the definitions in the Statement lack specificity which opens up lenders to huge liability risk, should the Statement become a regulation. AFSA remains concerned that requiring lenders to underwrite and qualify borrowers based on a fully indexed rate will close the door on many potential borrowers being able to achieve homeownership and exacerbate the ability of many to refinance prior to a resetting of the interest rate on their

current loan. Indeed, in July the CSBS/AAMR and NACCA issued their parallel guidance on X.

AFSA encourages the Board to refrain from using its HOEPA authority because the Statement provides significant restrictions that address the concerns raised in the hearing. At a minimum, AFSA asks the Board to allow the market time to react to the guidelines in the Statement before considering additional action. Currently, mortgage lenders are going through numerous adjustments in response to market pressures, the Nontraditional Mortgage Guidance, and the Statement. Lenders need time to adjust to these changes. Further, AFSA encourages the Board to conduct a complete assessment of how the Statement impacts the availability of credit to subprime borrowers. If AFSA is correct in its view that the Statement will result in significant reduction in the availability of subprime credit, we would encourage the Board not to use its HOEPA authority which would reduce availability further.

However, AFSA understands that the Board is under significant pressure to promulgate regulations. If the Board does decide to use its HOEPA authority, we respectfully request that the Board limit its rulemaking in the following ways.

A hardline requirement that subprime lenders escrow for taxes and insurance will significantly impact the availability of subprime loan products. Currently, a number of subprime lenders (both small and large) do not have the systemic capability to require a separate escrow account for its customers. Traditionally, escrow for taxes and insurance on subprime products was unnecessary because most consumers, including subprime, had a first mortgage product that included escrow for taxes and insurance. As subprime lenders have moved towards first mortgage lending, including purchase money, there has been an increase in the need for this option for consumers. Therefore, we recommend that to the extent any mandate of escrow for taxes and insurance is contemplated, such mandate include reasonable timelines and, if more immediate action is required, mandate disclosure as opposed to mandatory escrow. To do otherwise will impact the availability of subprime products.

Rulemaking could be promulgated to require that nonprime consumers be given an early, plain-language disclosure at or immediately after application explaining the benefits of having an escrow account, estimating the consumer's likely tax and insurance costs and illustrating how including such costs would affect their monthly loan payment. This would not eliminate valuable options for consumers, but would ensure that they are well-informed as to the specifics of their loan. In addition, the underwriting should include taxes and insurance – will go back

Rulemaking could also require that a plain-language disclosure to be given at or shortly after the time of application and again at closing regarding any prepayment penalty, including clearly describing its terms and a simple explanation of the potential benefits and detriments of accepting a loan with a penalty provision. A targeted

regulation should also include substantive requirements that: provide the consumer with a choice of not accepting a penalty provision, limit the term of the penalty to a maximum of three years (or in the case of an adjustable rate loan, 30 days prior to the first rate adjustment date in order to give the consumer additional time to secure refinancing, if desired, without incurring the penalty), and require the consumer receive a reasonable benefit in terms of lower up-front costs or a lower interest rate in exchange for electing the penalty provisions (and that the amount of the penalty be reasonable in light of the benefit provided).

AFSA believes that more can and should be done to provide consumers with clearer, more easily understood disclosures regarding key loan terms. Accordingly, we recommend that the Board work with lenders, consumers, consumer advocates, brokers and other interested parties to develop and require by regulation, pursuant to section 105 of TILA, the use of enhanced early, plain-language disclosures in connection with all mortgage loans. We also think that a lender should be deemed to have met Board mandated disclosures if the lender uses disclosure forms issued by the Board.

AFSA also urges the Board to work with interested parties to develop an educational video to help educate borrowers on the mortgage finance process, including in clear, plain language such things as the basic types of mortgages, typical terms, warnings regarding potentially abusive terms or practices, and who the consumer can contact for additional help and information. This video, which might run 10-15 minutes and be available in a number of languages, should be made widely available on DVDs and online and should even be required to be shown to all borrowers, or at least to certain categories of borrowers.

With regard to “Stated Income” or “Low Documentation” loans, AFSA recommends that the Board require pursuant to its TILA section 105 authority that when stated income or low doc loans are made the consumer should be given an early, plain-language disclosure of key facts such as noting that the stated-income procedure is being used; that the loan rate will be higher than a fully-documented loan; that the consumer may choose to fully document income and receive a lower rate; and that intentionally misstating one’s income could involve fraud and make it more likely that the consumer would lose the home by not being able to repay the loan. The consumer should receive another such disclosure at closing.

AFSA also recommends that the Board issue guidance that would allow the origination of stated income or low doc loans, provided the lender uses enough other controls to have a reasonable basis for concluding that the consumer does have the claimed income, when: (a) Excessive risk-layering factors are not present; (b) The loan is refinancing another loan with the lender and the consumer’s payment history is favorable; and (c) The consumer is self-employed or paid cash or with respect to income from tips or other special circumstances.

CONCLUSION

AFSA appreciates this opportunity to provide its views to the Board in connection with the important topics addressed at the June 14 hearing. If it would be helpful to the Board, we would be happy to make AFSA staff and member firm personnel available to meet and discuss any of the points raised in this letter. Please address any questions or requests for additional information to the undersigned at (202) 466-8616.

Sincerely

A handwritten signature in black ink, appearing to read "Bill Himpler", written over a horizontal line.

Bill Himpler

Executive Vice President, Federal Affairs